

DATE: May 11, 2007

SUBJECT: Fiscal Year 2007/08 Budget

**Dear Mayor and Members of the City Council:**

I am pleased to submit the City Manager's Recommended Budget for Fiscal Year 2007/08. The Budget addresses community needs within fiscal constraints. For the first time since Fiscal Year 2001/02, we present a budget where General Fund revenues are sufficient to sustain current levels of spending. It will not be necessary to use reserves to balance the Budget. The comprehensive Budget for all funds reflects the City Council's commitment to long term financial planning, cost effective municipal services, and financial policies that recognize the need to fund future obligations.

Police Services will be enhanced by the addition of one officer for patrol, and by a focused effort on crime prevention and suppression in the central core. Street and park maintenance activities will remain "bare bones." Recreation services are projected to recover a greater proportion of their costs, freeing up discretionary resources for other priorities. We are also requesting a major investment in infrastructure made possible by redevelopment bonds.

The City Council adopted the Sustainable Budget Strategy in January 2004. The strategy required significant General Fund expenditure reductions and projected significant new revenues that were to be identified. By implementing the Sustainable Budget Strategy, it was projected that revenues would be brought into line with expenditures by June 30, 2008, so that deficit

spending would disappear. That goal will be reached with this Budget. In addition, the City Council adjusted the General Fund reserve target at that time to allow fund balance to be drawn down over several years while steps were taken to balance revenues and expenditures. The reserve target is still at a very safe level equal to 25% of estimated annual revenues. Through a rebounding economy and the addition of new businesses, sales taxes and property taxes have increased significantly. In addition, the City's General Fund will receive an additional \$700,000 per year in property taxes, beginning in 2007/08 as the result of the Redevelopment Agency's reduction in its borders.

At the 2007 City Council Goal Setting Retreat, the Council adopted the following policies:

- *The City Manager's Proposed Budget for Fiscal Year 2007/08 should result in an operating surplus in the General Fund of approximately \$550,000 as predicted in the most recent Five Year Forecast. The Budget proposes an operating surplus of \$359,242 which, when combined with \$212,000 in expected 2007/08 salary savings, would provide for a projected operating surplus of \$571,242, or slightly more than the Council's target. The projected \$571,242 surplus is presented in the General Fund Balance Projections special analysis on page 298. Salary savings were calculated at 1.5% of budgeted salaries and benefits, based upon average salary savings for the last 3 years.*

of the new Outdoor Sports Center, which the City plans to open in October 2007.

The City of Morgan Hill provides a high quality residential community balanced with a significant industrial and commercial base. Population increased by 3.1% as of January 1, 2007, to a level of 38,418. The City provides a broad range of services, including police protection, development and housing, water and sanitation services, streets and parks construction, maintenance, planning, engineering, code enforcement, recreation, general city administration, and support services. The City contracts with Santa Clara County to provide fire protection services and with South Valley Disposal and Recycling to provide solid waste collection services.

- The goal of “economic development” is to encourage both the growth of the local economy and its diversification. Morgan Hill is part of a regional economy. Morgan Hill businesses import raw materials and labor. They export goods and services throughout the region and the world. Morgan Hill residents are employed throughout the region. Morgan Hill retailers serve both City residents and others in the region. Therefore, it is difficult to identify economic indicators that apply strictly to Morgan Hill. Nonetheless, the following four indicators are important to City government because they drive the revenues needed to support City services, and reflect “the business climate” in our portion of the larger region.

**Retail sales:** As a whole, taxable transactions in Morgan Hill increased, but not all business types have expanded. The composition of those transactions has changed, reflecting stagnation in “general retail sales” and a boom in transportation related sales taxes,

based primarily upon vehicle sales and gasoline sales, which have increased to a level where they now represent 41% of all sales taxes received by the City.

Property valuation: The property tax base has consistently grown over the years. In some years, the increase was attributable to significant new construction in industrial and commercial property. Most recently, the growth is attributable to the construction of new homes and resale of existing residential property. For the tax year 2006/07, assessed valuation grew by more than 10% in the City.

Jobs: As measured by the number of jobs reported to the City through the business license tax process, the number of workers employed by the top 40 employers in the City remained constant at 6,600 from July 2005 to July 2006.

Hotel Occupancy: The hotels and motels of Morgan Hill are very dependent upon business travel. As measured by revenue from the Transient Occupancy Tax, these taxes have been gradually rising from the low point associated with the recession of the early 2000's and the impacts of 9/11.

When the local economy slowed, beginning in 2000, the City's policy of establishing prudent reserves proved to be critical. In response to the State's weak financial position and the significant past revenue shifts from local government to the State, the voters passed Proposition 1A in November 2004. This measure limited the State's ability to take new monies away from local government by requiring that the State meet certain requirements prior to taking money from local government and by requiring that any money taken be paid back to local government. It appears that the State will not shift any additional tax dollars away from the City or Agency in the near future.

As projected for Fiscal Year 2006/07, sales tax revenue has grown by approximately 6% from the prior year to a level of approximately \$6.5 million, or 18% more than the previous peak of \$5.5 million received in 2000/01, primarily due to new businesses and economic growth. For Fiscal Year 2007/08, we are forecasting modest growth of approximately 4% to a new level of \$6.8 million, dependent partly on sales from the new Target at the new DiNapoli retail center. Without the Target revenue, taxes are projected to increase by 3% next year. It is interesting to note that the average annual increase in sales tax revenue for the last 10 years has been 8.6%, with annual changes ranging from a 12.2% drop to a 27.7% increase. Transient occupancy tax revenue has increased by approximately 7% in Fiscal Year 2006/07, as projected, to a level of \$1.1 million, or 21% less than the peak of \$1.4 million received in Fiscal Year 2000/01. Growth of 3% is estimated for Fiscal Year 2006/07.

## **BUDGET PROCESS**

The Fiscal Year 2007/2008 Budget is based upon an in-depth analysis of actual and projected fund balances, revenues, and expenditures. The City Manager gave each General Fund department an initial target based on the difference between departmental expenditures and departmental revenues. Departments were instructed to meet these targets through expenditure reductions and/or revenue increases. Each City department prepared line item detail for the department's activities and recommended certain service levels and activity goals for the 2007/08 budget year. Departments prepared revenue projections and the Finance Department reviewed these projections. The City Manager then reviewed individual departmental requests, prioritized activities

The Budget relies upon a cost allocation plan that was prepared by a consultant in 2006 and updated in 2007/08 for the cost of inflation by staff. This plan ensures that general administrative overhead is properly and reasonably distributed to all cost centers.

- Acquire land for a future neighborhood park
- Complete Outdoor Sports Center Phase I construction project
- Develop new Water Well
- Implement City Council's direction for enhanced public safety services
- Plan & construct remodel of old library for the new Development Service Center
- Update development impact fees and development processing fees by working with a consultant to produce recommendations to ensure full and equitable cost recovery
- Develop five year revenue, expenditure, and fund balance projections for all funds
- Acquire right-of-way for Santa Teresa and Butterfield Boulevard Extension projects
- Issue Redevelopment Agency tax increment bonds (up to \$100 million over 5 years) and develop the Redevelopment Infrastructure Investment Plan
- Implement the franchise tow program
- Complete Southeast Quadrant Sports/Recreation Land Use Study and Urban Limit Line
- Complete Downtown Plan Update & Implementation including Parking Management Plan

- ## HIGHLIGHTS - FISCAL ISSUES

The total budget for Fiscal Year 2007/08 (including capital projects, Redevelopment Agency appropriations, and transfers out) is \$141,003,315, or \$21,192,894 more than the original 2006/07 budget. The Budget includes a Capital Improvement Program (CIP) of \$41.5 million for new projects in 2007/08 and includes a transfer of \$15.0 million from the Redevelopment Agency for the purchase of sewer capacity using Agency bond proceeds.





Officers Association. Increases for police, management and confidential employees have been estimated in the Budget at amounts consistent with the five year forecast.

The proposed General Fund budget is a “status quo” budget except for the addition of the 3.5 public safety positions. The guiding principle has been to maintain current staffing and to increase staffing only where such additions are essential. An already “lean” organization has been challenged to deliver an ambitious work plan. We are proud of the accomplishments of the City’s employees and their continued commitment to public and customer service.

The City Council has indicated that it will seek creative ways to engage the public in discussions before any new funding sources requiring voter approval are proposed. The input from the community will prove valuable as the Council determines the next steps. Additional staffing to address growing needs and a higher level of service will require higher levels of revenue.

***For the proposed Fiscal Year 2007/08 Budget, the following specific steps were taken to balance the budget and provide adequate funding for necessary services:***

- Transfer the remaining \$50,000 from the Community Centers Start-up Fund to the General Fund for Centennial Recreation Center start-up costs
- Increase the annual transfer from the Park Maintenance Fund to the General Fund by \$151,655 to a new level of \$276,655
- Restore an annual transfer out of the General Fund to the Street Operations Fund in the amount of \$100,000 to enable the Street Operations Fund to meet minimal maintenance requirements.
- Change the amortization period for the current unfunded actuarial accrued

liability for the CalPERS miscellaneous employees pension plan from a rolling 30 year period to a fixed 22 year period. This change will reduce the employer rate paid by the City by 0.002% in the near-term and will mean that the current pension liability will get paid off over this time period rather than increase with negative amortization over the same time period.

- ***While the City has reduced certain less critical services in recent years, it also has not addressed the following needs because of limited funding:***
- Additional sworn police positions needed for enhanced patrol, traffic enforcement, and investigative caseload.
- Increased staffing on California Division of Forestry fire trucks.
- A third fire station in Morgan Hill.
- A third dedicated School Resource Officer for the Police Department.
- Deferral of the following development processing audit consultant recommendations:
  - Implement automated permitting and project tracking
  - Create a Building Maintenance Supervisor position
  - Acquire ability to integrate Geographic Information System with permitting system

### **HIGHLIGHTS - CHANGES IN BUDGET FORMAT & SPECIAL ANALYSES**

Activity related to Street capital projects has been separated from Street Maintenance Fund #302 and is now accounted for in a new fund #308 entitled “Street CIP Fund.” Only costs related to the repair and rehabilitation of streets will be accounted for in the Street Maintenance Budget. Because the Street CIP Fund will account for grants, which

community. The City's costs, especially for employee benefits, have increased significantly primarily for reasons beyond the City's control. While retirement costs and workers compensation costs have stabilized, health related costs continue to escalate by 10% per year.

Because the City has prudently built up financial reserves over the previous decade, Morgan Hill is in a position to carefully manage a response to this challenge without resorting to dramatic service level reductions or immediately increasing taxes.

However, unless there are long-term structural changes to increase General Fund revenues, the current level of basic city services is not sustainable. Over the past five years, General Fund reserves have been used to balance the Budget. In the current year, the Budget reflects a surplus only because of an increase in General Fund property tax receipts attributable to the reduction in the size of the Redevelopment Agency boundaries. While higher property tax and sales tax growth help out, our conservative General Fund Balance Projections (see page 298) show that the annual operating surplus will steadily decline from 2007/08 to a positive level of only \$48,000 in 2011/12 even without adding any additional positions. New retail/sales outlets and new construction above our projections will enhance the long-term sustainability of the Budget.

- Recreation Revenues and Expenditures
- Current & Future Grants
- Discretionary Reserves
- General Fund Balance Projections
- General Fund Discretionary Revenues
- General Fund Discretionary Expenditures
- Police Staffing
- PERS Retirement Historical and Projected Costs
- Carbon Footprint
- Relationships with Other Agencies
- Sustainable Budget Strategies

## GENERAL FUND

The fiscal squeeze is still real, and it must be addressed if the community's priorities for services and governance are to be met. The City Council is responsible for establishing policies that meet community needs and lead to balanced budgets; and it is the responsibility of City staff to implement such policies in a manner that achieves the desired results, builds confidence, and prepares for the future. Fulfilling these responsibilities

The City has a balanced budget for 2007/08, as proposed, and staffing levels have been maintained, but caution should still be exercised. The City faces the budget challenge that the local economy is not generating sufficient revenue to sustain current services on an ongoing basis as the City grows. In addition, the City does not have the revenue stream that would allow the City to expand service levels to the





Based upon the City Council's established policy, a total of \$6,136,912 has been reserved within the General Fund as a general reserve for purposes that include economic

The remainder of the General Fund accounts for General Government operations (City Council, City Clerk, City Manager, Finance, Human Resources, and City Attorney), Park Maintenance and Recreation Services. A significant portion of the administrative cost for General Government Operations is recovered in the form of charges to other City departments for services performed. Operating costs for the Community & Cultural Center, Aquatics Center, Centennial Recreation Center, and new Outdoor Sports Center are reflected in the General Fund, creating opportunities and commitments. A schedule of revenues and expenditures for Recreation, including the Community and Cultural Center, Aquatics, and the Centennial Recreation Center, for the period 2004/05 through 2007/08, is included in the Supplemental Information section. The net impact of Recreation activities is projected to decrease to \$1,378,076 in 2007/08. For the Centennial Recreation Center in 2007/08, \$50,000 is proposed to be transferred from the Community Recreation Centers Start-up Fund to partially cover the final start-up costs for this new facility.

The most significant sources of General Fund revenues for 2007/08 are:

- Sales Taxes of \$6,790,000, or 27% of total estimated revenues
- Property Taxes of \$6,791,179, or 27% of total estimated revenues
- Recreation Program Revenue of \$3,894,584, or 15% of total estimated revenues
- Reimbursement for General Administration Overhead of \$1,987,792, or 8% of total estimated revenues
- Transient Occupancy Taxes of \$1,135,163, or 4% of total estimated revenues
- Franchise Fees of \$1,120,753, or 4% of total estimated revenues

The following chart shows how much of the Fiscal Year 2007/08 General Fund budget is supported by discretionary general taxes and other revenues paid by residents and businesses. As shown below, all General Fund costs not recovered through departmental revenues (fees, grants, and reimbursements) are fully financed by discretionary revenues.

Department	Total Costs	Less Dept Revenues	Less Transfer In	Net Costs	Percent of total
City Council/City Clerk	\$ 638,023	\$ 472,981	\$ -	\$ 165,042	1.00%
City Attorney	577,191	380,336	-	196,855	1.10%
City Manager	499,918	238,605	-	261,313	1.50%
Recreation	5,381,169	3,894,584	108,509	1,378,076	7.90%
Human Resources	535,625	252,279	-	283,346	1.60%
Finance	1,076,139	817,707	5,150	253,282	1.50%
Police	10,517,324	481,804	531,274	9,504,246	54.60%
Fire Administration	4,868,611	216,000	-	4,652,611	26.70%
Cable Television	28,674	28,000	-	674	0.00%
Park Maintenance	742,935	-	276,655	466,280	2.70%
Transfers Out	244,386	-	-	244,386	1.40%
<b>TOTALS</b>	<b>\$25,109,995</b>	<b>\$ 6,782,296</b>	<b>\$ 921,588</b>	<b>\$17,406,111</b>	<b>100.00%</b>

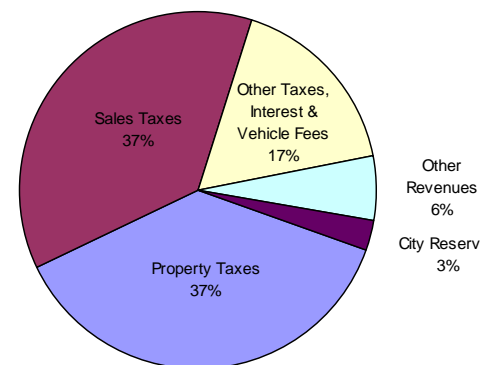
Financed by Discretionary Revenues

\$17,406,111

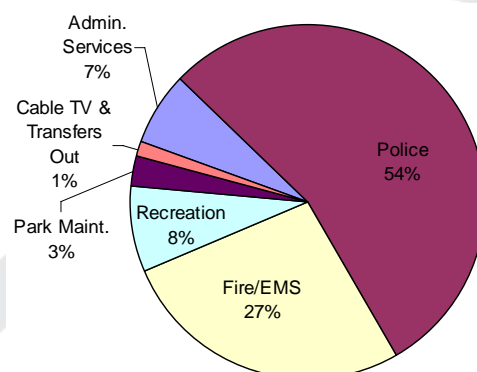
As shown above, \$17,406,111, or 69%, of the \$25,109,995 General Fund budget is financed by discretionary revenues. In the prior year, projected discretionary revenue equaled \$16,387,403, or 71% of total General Fund projected costs. Public safety accounts for \$14,156,857, or 81%, of total discretionary revenues in 2007/08.

The sources and uses of discretionary revenues are displayed in the following two pie charts. The first chart shows the major sources of discretionary revenues for Fiscal Year 2007/08. Together, sales taxes and property taxes make up \$13,581,179, or 78% of discretionary revenues that will finance General Fund expenditures. An additional amount of \$359,242 in discretionary revenues will increase General Fund reserves, as proposed. The second chart shows the uses of discretionary revenues for 2007/08, as described above.

### Discretionary Revenues

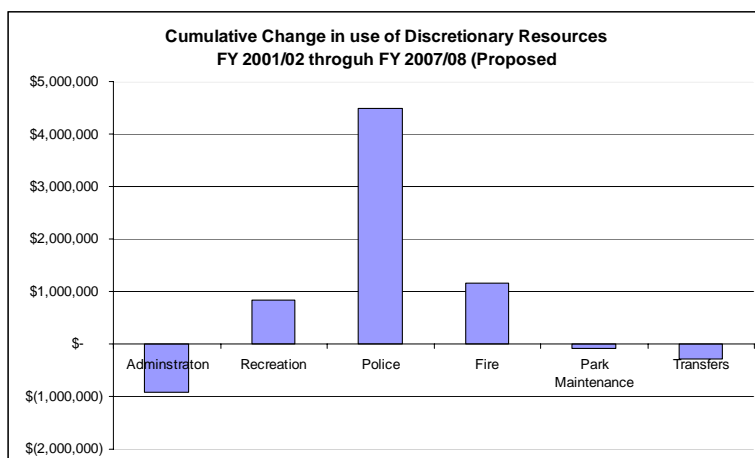


### Use of Discretionary Revenues



Since the City has faced a structural deficit for the last five years, it is useful to see where the increase in the use of discretionary dollars has been spent. The following bar chart

shows cumulative changes, totaling **\$3.3 million dollars**, in the use of General Fund discretionary dollars between Fiscal Years 2001/02 and 2006/07. The chart shows that the City has clearly spent most of the growth in discretionary dollars for public safety.



## COMMUNITY DEVELOPMENT FUNDS

The Community Development Fund is a special revenue fund used to account for services supporting private development activity. The fund is dependent upon the collection of planning, building, and engineering development fees to finance these costs. This year appropriations are \$3,901,799, which represents an 11% increase over the original prior year budget. Revenues in Fiscal Year 2007/08 are estimated to be \$2,932,837, or 13% less than prior year budgeted revenues. The reduction in estimated revenues is the result of the timing of developer fee payments. The proposed 2007/08 City Work Plan includes hiring a consultant to assist the City in reviewing current development processing fees and proposing adjustments as needed.

The General Plan Update Fund continues to provide the resources for the General Plan Update. The General Plan Update effort is critical for the City as it provides the basic

policy blueprint on growth, development, and services. The costs associated with this activity are partially financed through a 5% surcharge on all building and planning permit fees.

## STREET MAINTENANCE FUND

The Street Maintenance Fund is a special revenue fund used exclusively for street maintenance and traffic safety activities. Included are maintenance and repair of all roadways, streets, curbs, gutters, medians, roadway shoulders, and alleys; cleaning and repair of catch basins and storm drains; traffic engineering, safety studies and modifications, and related geographic information systems; street lighting

and signal operations; and painting, marking, and striping. State gas tax funds that partially finance these activities are distributed based on population.

Revenues, including transfers in, are budgeted as \$1,605,300, including \$704,750 of Gas Tax funds, a \$155,000 transfer from the Environmental Programs Fund, a \$100,000 transfer from the General Fund, \$600,000 in transfers from utility funds, and \$45,550 in other revenue. The small transfer from the General Fund reinstates a practice the City employed up until 2003/04, when such transfers ceased due to budget constraints. Without this General Fund transfer, the Street Maintenance service level would be reduced by turning off up to half of the residential street lights. The \$155,000 transfer in from the Environmental Programs Fund reflects a \$5,000 increase from the prior year that is necessary to help maintain the City's streets. The fact that gas taxes received by the City do not increase with inflation limits the City's ability to maintain streets in the future.

In order to manage the Street Maintenance Budget as dedicated Street Maintenance resources become scarcer, the proposed Budget separates the repair and rehabilitation costs of Street Maintenance from Street capital projects by moving Street capital project activity to the new Street CIP Fund, as mentioned earlier.

## **PARK MAINTENANCE FUND**

The Proposed Budget for Fiscal year 2007/08 includes a transfer from the Park Maintenance Fund to the General Fund equivalent to \$276,655, or  $\frac{3}{4}$  of this fund's prior year actual revenue as shown in the City's comprehensive annual financial report. This complies with the City Council goal for assistance from this fund by increasing the transfer to the General Fund from the 2006/07 amount of \$125,000 and by still allowing ongoing growth in the Park Maintenance Fund, so that it may serve as an "endowment" fund for park maintenance. Revenues come from double park fees and from previous one-time General Fund transfers of "excess" General Fund reserves. The Park Maintenance Fund Balance is projected to be approximately \$4.3 million as of June 30, 2008.

The projected annual cost of maintaining the grounds adjacent to the new Library are estimated to be \$20,000. This cost will be financed with a portion of the lease payments to be received, beginning in April 2008, from the County Library JPA.

## **SEWER AND WATER FUNDS**

These are enterprise funds, where all costs incurred are covered by fees and charges paid by users of the systems. Presently, the City has approximately 11,600 accounts (including residential and business customers). The City water system meets or exceeds water quality

standards. Budget details for these funds are found under the Public Works section of the budget document and are described as Water Operations and Sewer Operations. The Fiscal Year 2007/08 Water Operations budget reflects no rate increase and no increase in the current 15% perchlorate rate surcharge. The 2007/08 Sewer Operations budget also does not reflect any rate increase. However, both sewer and water rates are the subject of a study currently being conducted by the City's rate consultant. It is expected that the consultant's report will recommend that both water and sewer rates be increased. That report will probably be presented to the City Council early in 2007/08. It is clear that the level of spending for sewer operations and maintenance is adequate for next year, but cannot be sustained without a significant rate adjustment in the future because of a structural deficit in the Sewer budgets financed by rate payers. For example, in 2007/08, the combined cost for the Sewer Operations, Sewer Rate Stabilization, and Sewer System Replacement Fund will exceed rate revenue and other revenue by a combined \$2 million.

The Sewer Operations Fund budget of \$7,396,377 is 11% more than the prior year's budget because of higher operational costs for wastewater treatment. The Water Operations Fund budget of \$10,432,376 is 19% more than the prior year primarily because of a \$1,581,646 transfer out to the Water System Replacement Fund for capital projects. Sufficient fund balance, combined with estimated revenues, exists within each of these funds to fully finance these costs in 2007/08.

The Wastewater Impact Fund budget includes \$5,162,000 in capital project costs, while the Water Impact Fund includes \$1,805,000 in capital projects. In addition, the Budget



CITY OF MORGAN HILL • FY 2007/08 - OPERATING AND CIP BUDGET

## CAPITAL PROJECTS FUNDS

- Parks and Recreation projects totaling \$6,256,000
- Public Facilities projects totaling \$2,842,000
- Sanitary Sewer projects totaling \$6,292,000

- Butterfield Boulevard Extension South (\$5.9 million for acquisition)
- Parks Land Purchase (\$2.1 million for acquisition)
- Pavement Rehabilitation System (\$1.3 million for construction)
- Highway 101/Tennant Interchange (\$3.6 million for design and beginning of construction)
- Tilton Avenue/UPRR Safety Improvements (\$1.2 million for construction)
- Downtown Parking (\$2.2 million for acquisition)
- Third Street Promenade (\$2.0 million for construction)
- Santa Teresa Construction (\$2.2 million for acquisition)
- New Well Property/Construction (\$1.1 million for construction)
- Butterfield Detention Basin (\$2.1 million for acquisition)
- Sewer Plant Improvement Project (\$3.9 million for construction)
- Open Space Acquisitions (\$1.4 million for acquisition)
- Development Service Center (\$2.0 million for construction)
- New Sewer Mains (\$1.3 million for construction)

Many of these projects are possible because of the Redevelopment Agency. Of the total \$41.5 million in capital projects described in the CIP for Fiscal Year 2007/08, \$13.2

million will be financed by the Agency. It is proposed that the Agency issue tax increment bonds (up to \$100 million over 5 years) and embark on an ambitious program of investment in infrastructure and downtown improvements over the next five years.

### **APPROPRIATIONS LIMIT**

The City's appropriations limit for this budget cycle has been prepared in accordance with the uniform guidelines. The appropriations limit imposed by Propositions 4 and 111 creates a restriction on the amount of "proceeds of taxes" which can be appropriated by the City in any fiscal year. The limit is based on actual appropriations during Fiscal Year 1978/79, and increased each year using growth of population and inflation indexes. The limit of \$67,882,120 for Fiscal Year 2007/08 is significantly greater than the actual appropriations of \$17,082,589 subject to the limit for this year. Therefore, it appears that the City will not exceed its appropriations limit in the foreseeable future.

### **SUMMARY**

It is significant that the City finally has a proposed Budget with a positive operating margin, along with substantial reserves and resources on hand. However, it is important to note that the City still faces future costs to operate facilities, increased employee retirement costs, increasing employee health costs, and the demands of a growing community. While recent growth in property tax and sales tax revenue have been very welcome, current expenditures are tied to current service levels. The strong reserves maintained by the City reflect the foresight of the City Council and will allow the City to manage costs in a strategic manner.

I acknowledge my appreciation to the members of the City Council for your continued support of programs that deliver necessary public services and for your sound fiscal policy. I also express my appreciation for assistance in the development of this budget to the talented and dedicated City staff, including our new Budget Manager Mark Murray.

Respectfully submitted,



J. Edward Tewes  
City Manager